

Volume No. 1—Policies and Procedures	TOPIC NO	31215
Function No. 30000—Fixed Asset Accounting	TOPIC	LAS Transactions
Section No. 31200—Lease Accounting	DATE	December 2001

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Overview

Introduction This topic provides guidance about entering into lease agreements and ensuring proper classification of leases and handling leasehold improvements. All financial information related to property, plant and equipment lease agreements must be properly recorded and accounted for on the books of the Commonwealth with appropriate reporting and disclosure in agency and Commonwealth financial statements in accordance with generally accepted accounting principles (GAAP). The following procedures assist to ensure compliance with these requirements.

Policy

General Agencies must ensure that proper determination is made as to whether an agreement to acquire property, plant or equipment is a lease. If it is a lease, proper classification must be determined in order to accurately record, account for and report on the acquired asset. If it is not a lease, CAPP Section No. 31200—*Lease Accounting*, is not applicable. Instead, CAPP Sections 30100 thru 31100 covering the Fixed Asset Accounting and Control System (FAACS) would be applicable.

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Procedures

Installment Purchases

If title passes upon signature, the agreement is an installment purchase and should not be recorded in the Lease Accounting System (LAS). If the asset passes the FAACS input requirements (see CAPP Topic No. 30305—*Capitalized or Controlled Assets*) it should be recorded in FAACS.

Lease Agreement

Whether title passes during or at the end of the agreement or does not pass at all, it is considered a lease and should be recorded in LAS.

When title does not pass, such a lease would normally have either

- an initial non-cancelable term of one year or more, or
- payment terms of \$500 per year or more.

If either of these conditions is met, the lease must be recorded in LAS.

If neither condition is met, the lease is not required to be recorded in LAS, but may be for control purposes.

Once an agreement has been determined to be a lease, include the following information in the lease agreement to properly classify the lease and maintain data integrity used to perform an economic analysis, if appropriate (See CAPP Topic No. 70605—*LAS Input Documents*, for instructions to complete lease forms.)

- **Fair Market Value:** See Definitions in CAPP Topic No. 31205—*Introduction*. This value typically is the purchase price and may obtained from the vendor or it may be independently verified by the agency with and for the following:

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Procedures, Continued

Agency	Item to be Valued
Department of Information Technology (DIT)	Electronic data processing equipment
Department of General Services, Division of Engineering and Buildings	Real Estate
Department of General Services, Division of Purchases and Supply	All other items

- **Incremental Borrowing Rate:** See Definition CAPP Topic No. 31205—*Introduction*.
- **Executory Costs:** See Definition CAPP Topic No. 31205—*Introduction*.
- The lease term and the amount and frequency of the lease payments.
- Any terms and conditions regarding renewals or penalties.
- Any options or bargains which transfer (or reasonably ensure transfer) of ownership, of the

Is It a Capital or Operating Lease?

Lease Classification

Leases are classified as either operating or capital leases from the lessee's standpoint. Recording the expenses associated with the lease and determining whether the asset is recorded as owned or not for financial statement purposes depends upon how the lease is classified. This classification depends on the following conditions:

- the agency (lessee) using the asset will obtain ownership of the asset during or at the end of the lease term
- the agency will make enough payments to have, in effect, purchased the asset, or
- the asset will be used for most of its economic/useful life.

Operating Lease

If the agency is only using the asset for a short period of time, and will not take ownership or use up most of the asset's worth, then the lease is classified as an operating lease.

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Procedures, Continued

Capital Lease If the asset is essentially being paid for or used for most of its life, then the lease is classified as a capital lease whether the agency will acquire ownership or not. A capital lease is a lease that meets any one or more of the four tests set forth by the Financial Accounting Standards Board.

Lease Analysis Tests to determine lease classification are defined in CAPP Topic No. 31205—*Introduction*.

Agencies should perform an analysis of each prospective lease to determine if the lease is (1) operating or (2) capital in accordance with *SFAS No. 13*. DOA provides assistance with this analysis when requested.

Leases involving assets with an estimated current fair market value of less than \$5,000 will be considered operating by DOA. Property valued at \$5,000 and above will be subject to all four tests, unless the lease is for:

- Land (Title Transfer Test and Bargain Purchase Option Test only)
- An asset in the last 25% of its economic life (Title Transfer Test and Bargain Purchase Option Test only)
- Part of a building (Lease Term Test only)
- Part of a multiple building complex (Lease Term Test only), or
- A mobile/temporary building (Lease Term Test only).

Lessor's Lease Types When the Commonwealth (Agency) is the Lessor, a lease can either be a

1. direct financing lease,
2. sales-type lease, or
3. operating lease.

- A direct financing lease is a capital lease. The lease passes at least one of the four classification tests. For simplification, a direct financing lease is referred to as a capital lease throughout this manual.
- A sales-type lease is also a capital lease. It differs from the direct financing lease in that the lease gives rise to a profit on the transaction (beyond interest income) to the lessor. Since the State does not incur profit when it is the lessor, this type of lease should not occur.
- An operating lease does not meet any of the four criteria used to classify a lease as being capital. (See CAPP Topic No. 31205—*Introduction*.)

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Procedures, Continued

Leasehold Improvements Must Be Capitalized

Permanent improvements to leased assets are considered an integral part of the leased property and must be capitalized in FAACS.

Such improvements represent items that cannot be removed without substantially damaging or requiring substantial repair to the leased asset. Therefore, the capitalized leasehold improvement cost should be depreciated over either the (1) term of the lease or (2) service life of the improvement, whichever is shorter.

To determine lease term for depreciating capitalized leasehold improvements, renewal or option-year provisions are to be ignored.

Recording Leasehold Improvements in FAACS

Leasehold improvements are entered into FAACS using special nomenclature codes for leasehold improvements. Capital assets merely located on leased property and not permanently installed should be recorded in FAACS using the FAACS nomenclature code to reflect the assets class (See CAPP Topic No. 30315—*Nomenclature Codes*.)

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Internal Control

General

Each agency and institution should implement cost-beneficial internal control procedures to ensure that:

- All potential agreements to acquire property, plant and equipment are properly evaluated to determine if the transaction is truly a lease.
- All leases are properly classified as either operating or capital.
- All leasehold improvements are properly evaluated for inclusion in FAACS.

Records Retention

General

Fiscal records related to managing fixed assets should be retained for a period of 2 years plus current fiscal year, or until audited, whichever is greater. However, for pending, ongoing, or unresolved litigation, audits or claims, retain documentation until completion, resolution, or negotiation of settlements.

Destruction of records must be in accordance with policies and procedures of the Records Management Section, The Library of Virginia.

DOA Contact

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Subject Cross References

References

CAPP Topic No. 30305—*Capitalized or Controlled Assets*

CAPP Topic No. 30315—*Nomenclature Codes*

CAPP Topic No. 31205—*Introduction*

CAPP Topic No. 31220—*LAS Reporting*

CAPP Topic No. 70605—*LAS Input Documents*
